THE LIABILITY OF THE INACTIVE CORPORATE DIRECTOR.

Whether the position of a corporate director be treated as analogous to that of an agent or to that of a trustee,[1] it seems to be assumed that a director's violation of duty or breach of trust, in either case, may be clearly defined and adequately redressed. Whether such breach consist of specific wrongdoing or of such conscious inaction as constitutes the variable error of "gross negligence," the liability of the director has been repeatedly recognized. Where, however, the conduct of the director involves no act which may in itself be deemed improper, and where there has been no such inaction as may be construed to be "gross negligence," a somewhat different problem arises. To what extent may a corporate director properly, or safely, permit the affairs of the corporation to be managed by his fellow directors without becoming in some degree liable, through his inaction, for any waste or other damage resulting from their improper conduct? To what extent may an inactive director be made liable for the wrongful conduct of his fellow directors in which he may not have participated, of which he may not even have had knowledge, and his connection with which arises simply from his membership upon the same board? These considerations suggest the inquiry whether the responsibility attaching to mere membership in a board of directors has been, as a matter of law, as clearly defined as the standards of business and of public policy require. The problem has been frequently adverted to, and while there may appear a disinclination to enlarge the liability of the inactive director, there nevertheless has resulted no precise or adequate rule of law. To attempt to state any such rule, as a matter of theory, may be impossible and certainly would be futile; but a consideration of the tendencies makes manifest the security of the passive director and the insignificance (certainly so far as the confidence of stockholders and the public arising from the *personnel* of any board may be concerned) of membership upon a board of directors, and may emphasize the amount of decision and dictum which will require revision if the legal character of the corporate director is to be made more nearly identical with the practical conception.

[1] Or as like that of "bailee of the capital." Gardiner *v.* Pollard (1863), 10 Bosw. 674, 691.

Briefly stated, the really passive director has been deemed not responsible for the wrongdoings of his associates, since his own liability arises only from his actual participation in such wrongdoing; and, further, while he may be liable for the wrongdoings of his associates, though not joining in them, if he has knowledge of such transactions and remains inactive, yet if he is ignorant of such transactions certainly liability does not rest upon him. The natural consequence was suggested to Stirling, J., in *In re Cardiff Savings Bank.*[2] "It was much pressed on me that, if this be so, all the trustees and managers might abstain from acting, leaving the business to be transacted by the officers of the bank alone, and yet escape liability." That may well seem the logical, and, for all practical purposes, the disastrous result; and the full import of the argument was brought out by the weak rejoinder of the Court (having held that one without knowledge could not be made liable for the neglect and omission of others) in saying: "I have difficulty in seeing how this could happen without the knowledge of some at least of the trustees and managers." This, of course, is reasoning in a judicial circle, unless such a director is under a specific obligation to keep himself informed as to corporate affairs, which is not yet the case,[3] or unless there may be imputed to such a director knowledge which he does not in fact possess, which also is not the case. The reality of the problem is thus apparent. A recent typical case, though diverging somewhat in its conclusion from the earlier orthodox theory, illustrates the practical phase of the question, in holding that a court should not ignore the rights of innocent parties who confided in the corporation, "relying upon the protection which the names of these directors and a proper discharge of their duties held out to the public," and in the novel opinion that "if a person becomes a confirmed invalid for a number of years and unable" thus (or, apparently, from any cause) "to attend to the duties of a director, he has no right to hold on to the position and at the same time decline its corresponding responsibilities." [4]

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[2] L. R., 1892, 2 Ch. Div., 100, 110.

[3] "This point, however, involves the question, whether a director is not bound to make himself acquainted with what his co-directors are doing, and to take such steps as may be in his power to prevent them from doing wrong. On this question opinions differ, and it can scarcely be considered as settled." Lindley, Law of Companies, 6th Ed. (1902), vol. i, p. 529.

[4] Rankin *v.* Cooper (1907), 149 Fed. Rep., 1010, 1015, 1016.

So far as the element of mere non-participation is concerned, one of the earliest decisions is that of *The Charitable Corporation* v. *Sutton*,[5] the complaint in which set up certain "actual breaches of trust," and secondly such "manifest breaches of trust, or at least of such supine and gross negligence of their duty, and so often repeated, that it will amount to a breach of trust." The latter gave rise to "an accumulated charge" against all the fifty directors involved, but even under such circumstances Lord Hardwicke held that only those were liable who were "conniving at the affair." The passive director thus incurred no liability because of the misdeeds of his associates. As was said in *Attorney-General* vs. *Wilson*,[6] "It is evident that Lord Hardwicke, in the case of *The Charitable Corporation*, considered that each defendant would be liable for each transaction in which he had been a party." Acting upon this interpretation, the Court, in this later case, gave relief only against "those members of the governing body who were instrumental in carrying into effect the acts complained of." The decree in *Evans* v. *Coventry*[7] was apparently framed on this theory so as to cover only those transactions in which the defendants had taken part, Lindley, L. J., taking this view when in a later case he remarked: "I have carefully looked at the decree in *Evans* v. *Coventry*, and I infer that the directors there held liable not only passed resolutions that were *ultra vires*, but also acted on them."[8] Following these precedents, Jessel, M. R., in *In re National Funds Assurance Company*,[9] directed that the order should be made "limiting of course the liability of each director to those sums which he participated in paying." Keeping within the limitation thus clearly established the Court in *Flitcroft's Case*[10] merely held directors liable "not only for what they put into their own pockets, but for what they in breach of trust pay to others," and in the same year the facts in *In re Anglo-French Co-operative Society*[11] were treated as involving "a simple paying away of this money * * * by the directors." The liquidator in *Grimwade* v. *Mutual Society*[12] accordingly

[5] (1742), 2 Atk., 400. [6] (1840), Cr. & Ph., 1, 28, 29.

[7] (1857), 8 D., M. & G., 835.

[8] Cullerne *v.* The London and Suburban G. P. B. Society (1890), L. R., 25 Q. B. Div., 485, 489.

[9] (1878), L. R., 10 Ch. Div., 118, 129.

[10] (1882), L. R., 21 Ch. Div., 519, 536.

[11] (1882), L. R., 21 Ch. Div., 492, 506.

[12] (1885), 52 L. T., 409, 415.

sought "to charge the directors with such only of the loan transactions as they personally took part in during their tenure of office." In *London Trust Co.* v. *Mackenzie* [13] the non-participating director was exempted, while in *Young* v. *Naval, Military and Civil Service Society* [14] it was held that a director, although present at the adoption of a resolution under which improper payments were made, was nevertheless held liable to refund, in addition to the amounts he had himself received, only the amount which he had, by signing the check, participated in diverting, and was not held liable with respect to amounts received by other directors under the same resolution and with his knowledge. This extreme of immunity seems to have been foreshadowed by the statement of Lindley, L. J., in *Cullerne* vs. *The London and Suburban G. P. B. Society:* [15] "The plaintiff ought not to have passed the resolutions, and his co-directors ought not to have acted on them. I am not aware of any authority which goes the length of deciding that under these circumstances the plaintiff is liable for what they have done. They were not his servants or agents; their authority was as great as his; their knowledge the same as his; and, even assuming that he misled them upon a point of law, this does not make him liable to the society for the loss of money which they advanced and not he." The rule has been briefly stated in *Fisher* v. *Graves,*[16] as follows: "At common law[17] one director does not seem to be liable for the misconduct of co-directors not participated in, as a wrongdoer, by him." The Court was controlled by the opinion expressed, with a perfectly consistent qualification, in *Briggs* v. *Spaulding,*[18] to the effect that directors "cannot be held responsible for losses resulting from the wrongful acts or omissions of other directors or agents, unless the loss is a consequence of their own neglect of duty, either for failure to supervise the

[13] (1893), W. N., 9.

[14] L. R., 1905, 1 K. B., 687, 696.

[15] (1890), L. R., 25 Q. B. Div., 485, 489.

[16] (1897), 80 Fed. Rep., 590, 591.

[17] But the liability of a director under the national bank act has been held to be substantially the same as at common law. Clews *v.* Bardon (1888), 36 Fed. Rep., 617.

[18] (1890), 141 U. S., 132, 147. The correctness of this decision is questioned in Thompson, Corporations, sec. 4111; cf. Robinson *v.* Hall (1894), 63 Fed. Rep., 222, 227.

business with attention or in neglecting to use proper care in the appointment of agents."[19]

Thus there is found reiterated and controlling affirmance of the principle that the passive director is exempt from liability for the wrongful conduct of his associates, and indication in the same connection that the passive director, even when possessed of knowledge of the circumstances, may be regarded as equally free from liability. Certainly if the passive director is ignorant of the material circumstances his immunity is clearly recognized. This second proposition has been so repeatedly stated that it has become quite as much a fixed principle as has the proposition already illustrated.

In an opinion referred to above the Court said: "To hold that the Marquis was guilty of neglect or omission in respect of this duty, in the absence of any knowledge or notice that it was not duly performed, would, in my opinion, be to fix him with the liability for the neglect and omission of others rather than his own."[20] The "conniving" of Lord Hardwicke, also, would seem to involve knowledge as an essential element in determining liability, and it has been held that knowledge of, as well as participation in, the wrongful act "must be brought home to the person charged."[21] After referring to some of the more recent cases,[22] Vaughan Williams, J., said: "But in no one of those cases can I find that directors were held liable unless the payments were made either with actual knowledge that the funds of the company were being misappropriated or with knowledge of the facts that established the misappropriation."[23] The same principle, although applied to the acts of subordinates rather than of co-directors, has more recently been adopted by Halsbury,

[19] Recognizing, or assuming the existence of, the principle, are: Ernest *v.* Croysdill (1860), 2 D., F. & J., 175, 193, 194; Cargill *v.* Bowers (1878), L. R., 10 Ch. Div., 502; *In re* Oxford Benefit Building & Investment Society (1886), L. R., 35 Ch. Div., 502; *Re* Liverpool Household Stores Association (1890), 62 L. T., 873, 879; *In re* Sharpe, L. R., 1892, 1 Ch. Div., 154, 169; *In re* Lands Allotment Company, L. R., 1894, 1 Ch. Div., 616.

[20] *In re* Cardiff Savings Bank, L. R. 1892, 2 Ch. Div., 100, 110.

[21] Arthur *v.* Griswold (1874), 55 N. Y., 400, 406.

[22] *In re* National Funds Assurance Company (1878), L. R., 10 Ch. Div., 118; Flitcroft's Case, L. R. (1882), 21 Ch. Div., 519; *In re* Oxford Benefit Building and Investment Society (1886), L. R., 35 Ch. Div., 502; Leeds Estate Building and Investment Company *v.* Shepherd (1887), L. R., 36 Ch. Div., 787; *In re* Faure Electric Accumulator Company (1888), L. R., 40 Ch. Div., 141.

[23] *In re* Kingston Cotton Mill Company, L. R., 1896, 1 Ch. Div., 331, 347.

L. C., in the statement that the charges "may be disposed of by the proposition that" he "was not himself conscious of any one of these things being done, and that unless he can be made responsible for not knowing these things, * * * the charges are not made out." [24] The general proposition as stated has been acted upon in other instances,[25] and is recognized by Lindley.[26]

Moreover, the passive director thus protected in his ignorance, is given a still more complete immunity by the application of the doctrine that there should not be imputed to such director "knowledge which he does not possess in fact." [27]

Advancing further into this field of irresponsibility the passive director may readily find justification in so far ignoring his duty as even not to attend the meetings of the board. Lord Hardwicke had this possibility in mind when he said: "To instance in non-attendance; if some persons are guilty of gross non-attendance and leave the management entirely to others, they may be guilty by this means of the breaches of trust that are committed by others." [28] But this dictum has been materially qualified. Thus, it has been admitted that one properly might attend at the board only occasionally,[29] and also that it "could not be expected that each member of so numerous a body should take a very active part in the management, or attend every meeting." [30] Similarly, Vice-Chancellor Bacon remarked: "He became a director . . . but he was not bound to attend every meeting of the directors. It is not part of the duty of a director to take part in every transaction which is conducted at a board meeting. His business or his pleasure may call him elsewhere, and it would be a most unheard of thing to say that if anything wrong were done at a board meeting, he being named among the directors but not present, he is

[24] Dovey *v.* Cory, L. R., 1901, A. C., 477, 485; affirming *In re* National Bank of Wales, Limited, L. R., 1899, 2 Ch. Div., 629, 672.

[25] Joint Stock Discount Company *v.* Brown (1869), L. R., 8 Eq., 381, 401; *Re* Montrotier Asphalte Company (1876), 34 L. T. (N. S.), 716; cf. Spering's Appeal (1872), 71 Pa. St., 11, 21.

[26] Law of Companies, vol. i, pp. 528-530.

[27] Hallmarks Case (1878), L. R., 9 Ch. Div., 329, 332, 333; *In re* National Bank of Wales, Limited, L. R., 1899, 2 Ch. Div., 629, 644; Wakeman *v.* Dalley (1872), 51 N. Y., 27, 32; Rudd *v.* Robinson (1891), 126 N. Y., 113, 121; cf. Ashhurst v. Mason (1875), L. R., 20 Eq., 225.

[28] The Charitable Corporation *v.* Sutton (1742), 2 Atk., 400, 405.

[29] *In re* Forest of Dean Coal Mining Company (1878), L. R., 10 Ch. Div., 450.

[30] *In re* Cardiff Savings Bank, L. R., 1892, 2 Ch. Div., 100, 108.

liable for what is done in his absence." [31] Emphasizing this view it has even been said that a director who for four years abstained from executing any of the duties of his office might be held not liable.[32]

The assurance of the passive director may seem still more complete by reference to the proposition, which has been given some recognition, that a director is under no obligation to attempt to prevent or to undo the wrongful acts of his associates. Thus, it has been suggested that no precedent could be found for holding that a director, having knowledge of improper conduct on the part of his associates, could be under any liability because he did not interpose to prevent possible loss.[33] So far as a director may be supposed to be under any obligation to attempt to undo the improper acts of his associates, the point has been squarely met by Justice Lindley: "I am not aware of any authority which goes the length of saying that a director who is not a party to any misapplication of a company's funds is liable for not taking legal proceedings to upset the transaction after the thing is done, and I do not think it would be in accordance with the principles applicable to these cases if we were now first to make a precedent of that kind." [34]

The passive director thus has the advantage of safeguards so complete as to render his title inapt, and indeed also to make this description of him seem to be no more than mere fiction. The illusion is not dispelled by applying to his conduct the "supine negligence" test of Lord Hardwicke, or the more modern and equally indefinite "gross negligence" test, by which in many instances the real difficulty of the situation suggested is not met at all. Nor does the test that a director shall give to the affairs of the corporation such attention as a prudent man would give to his own affairs furnish any rule of action according to which difficulties of the nature here suggested may be solved. The latter test has served rather as a supplement to, or explanation of, the gross negligence test, being in itself quite inapplicable to modern corporate conditions. The gross negli-

[31] *In re* Montrotier Asphalte Company (1876), 34 L. T., 716, 717.

[32] *In re* Denham & Co. (1883), L. R., 25 Ch. Div., 752; Cf. Warner *v.* Penoyer (1898), 91 Fed. Rep., 587, 594.

[33] Liquidator of the Caledonian H. S. Co. *v.* Curror's Trustee (1882), 9 C. of S., 1115, 1129, 1130.

[34] *In re* Lands Allotment Company, L. R., 1894, 1 Ch. Div., 616, 635; Cf. Movius *v.* Lee (1887), 30 Fed. Rep., 298.

gence test itself implies the existence of certain elements, as of knowledge, actual or imputed, of a duty and a conscious disregard of such, which make it also inapplicable to the typical case arising under circumstances such as have been described, while, naturally, the test applied in the fraud cases has no application here.

If, thus, the inactive director may leave undone all the things a trustee or an agent may leave undone and may take advantage of all the protection the law affords to persons acting in such other capacities, and at the same time may be under no duty to recognize any obligatory relation with respect to the conduct of his associates, it follows as a possible result, as here pointed out, or indeed as an inevitable result, that the real purposes for which directors are in fact chosen may be in large measure defeated. If, on the other hand, a directorship in itself means the assumption of any specific obligation other than the obligations one always is under with reference to one's personal conduct, then it would seem necessary that the attempt to apply to the director only such tests of propriety of conduct as are applied to the trustee and agent must fail and that there must be recognized in the position of a director some further element of responsibility which has not thus far been clearly developed. A dogma which earlier prevailed (strengthened, doubtless, by the circumstance that many corporations then were of the charitable type), and which has not yet disappeared, assumed that directors were rendering gratuitous service to stockholders and that accordingly there should be imposed upon the position of director as few obligations or hardships as possible, in order that men of the desired character would more readily accept election. If this idea proceeded from the supposition that it was desirable for the benefit of the stockholders or the corporation to secure as directors men of a peculiar qualification or standing, the stockholders on the other hand should be allowed to rely, in some degree at least, upon the effect of the same supposition. That reliance is frequently very real and of important consequences, but if such reliance is now to be entirely disregarded in determining the responsibility of directors, then the popular notion of the corporate director is not in harmony with the legal notion; and the only real question is whether the legal or the popular conception should prevail, whether really any desirable end is to be secured by adhering to the strict and perhaps inapplicable rules developed in the course of faltering attempts

to define the position and duty of a director. It may be said that this requires the substitution of a practical or ethical standard for an existing legal standard which, however fallacious, is certain; but such substitution is the normal method by which legal rules are often developed, and if in this instance the law cannot lend itself to such development, it fails of its purpose. That such modification of legal theory is necessary or proper need not now be urged, as the present purpose is merely to suggest the anomaly which has been allowed to persist.

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